Chief financial officer's report

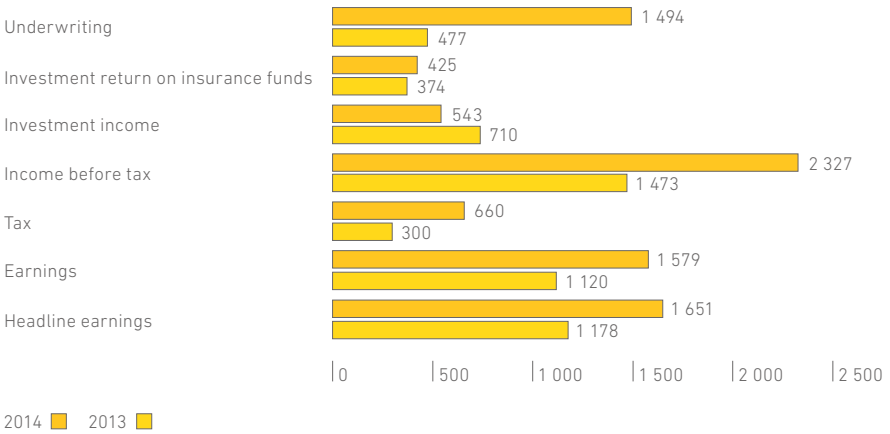
Overview

The Santam group reported strong underwriting results for the 2014 financial year with a net underwriting margin of 8.7% compared to 2.8% in 2013, significantly above the long-term target range of 4% to 6%. The results were positively impacted by improved contributions from all business units including a substantial turnaround in the crop insurance business. In addition, the absence of hail-related catastrophe events during the fourth quarter resulted in a better underwriting performance during the second half of the financial year compared to 2013. Satisfactory gross premium growth of 10% was achieved (12% excluding the cell insurance business) in challenging market conditions.

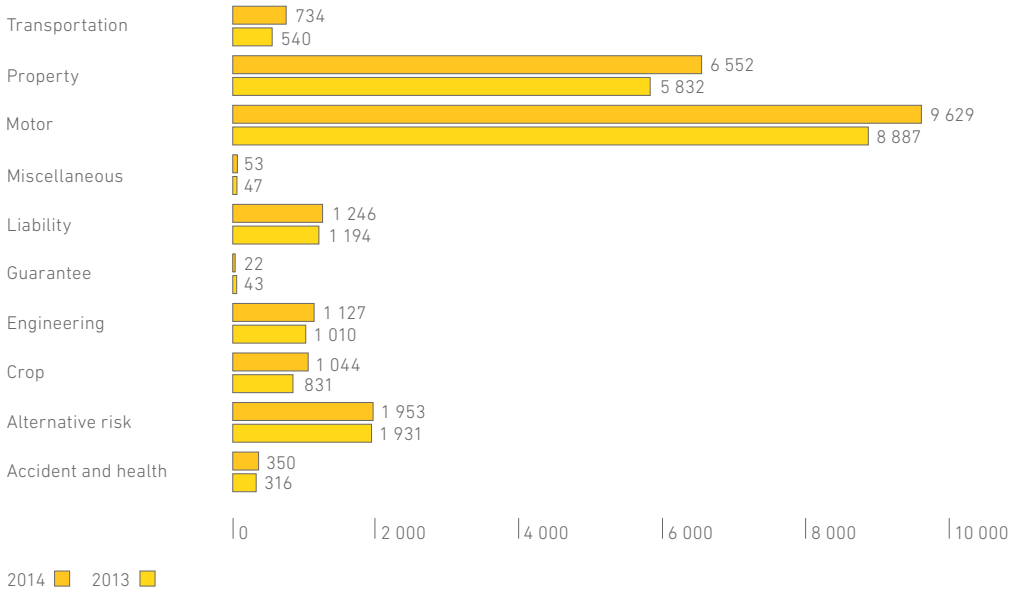
The investment portfolio performance was in line with market movements experienced during 2014, impacted by a positive contribution from the revaluation of Santam's interest in the SEM partner businesses and the negative impact of the fence structure over equities that expired during May 2014.

Headline earnings increased by 40% compared to 2013. Cash generated from operations increased to R2.4 billion (2013: R1.6 billion) on the back of the strong underwriting performance. The solvency margin of 45.6% marginally exceeded our long-term target range of 35% to 45%, while the group achieved a return on capital of 24.7% (2013: 20%).

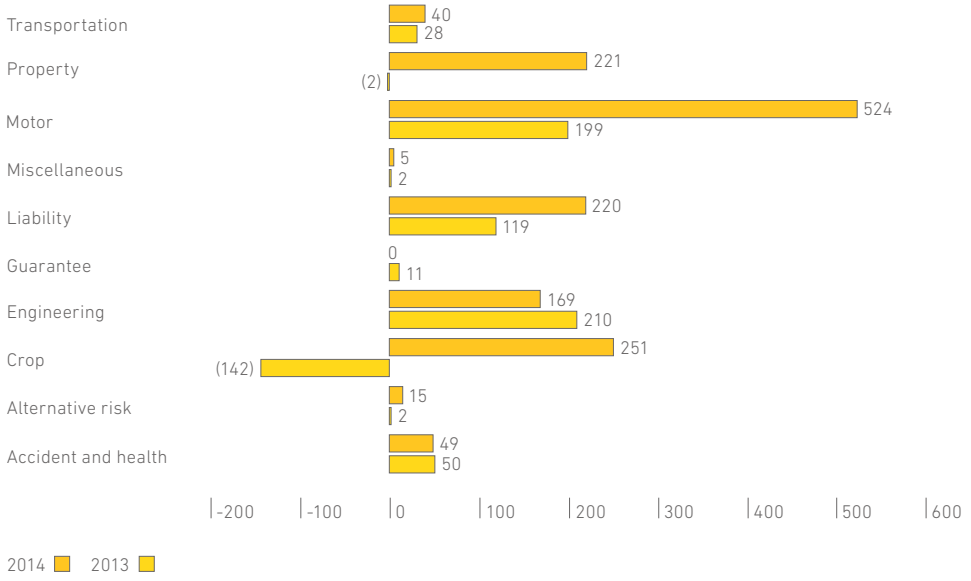
Main variances R'm



Gross written premium per insurance class R'm



Underwriting surplus per insurance class R'm



Financial results

A summary set of financial statements for 2014, prepared in accordance with IAS 34, is included in this integrated report. The full annual financial statements are available on our website at www.santam.co.za, or in printed format on request from the company secretary.

The key financial statistics are set out on page 4.

Economic environment

Real annual GDP slowed to 1.5% for 2014, which equates to low growth of insurable assets for the insurance industry. The interest rate environment remained relatively stable during 2014, with a 75 basis points increase in the repo rate. This resulted in more pressure on consumers and increased interest income for the group. The rand depreciated by 10% against the US dollar since January 2014, which placed strain on the group's insurance results as the weakened rand directly affects the claims cost (mainly imported motor parts).

Insurance results

UNDERWRITING PERFORMANCE

The net underwriting margin of 8.7% was significantly up compared to the 2013 margin of 2.8%, which was impacted by significant catastrophe events. It also exceeded the seven-year average of 6.0%.

The underwriting results of the motor and property business classes continued to benefit from the impact of corrective actions and segmented premium increases implemented since 2013. Furthermore, the motor and property classes benefited from fewer weather-related catastrophe events with no significant events in the last quarter of 2014. Santam's continued focus on optimising the claims and procurement processes also reduced the effect of the weakening exchange rate on motor claims. Our direct insurer, MiWay, achieved a claims ratio of 57.4% (2013: 62.2%, net of catastrophe reinsurance recoveries), resulting in an underwriting profit of R159 million (2013: R54 million).

The specialist property business delivered a strong performance despite a number of large property claims due to a positive contribution from the reinsurance programme.

Following corrective underwriting actions, with a specific focus on previously underperforming portfolios, liability business showed a significant improvement compared to 2013.

The engineering class was under some pressure due to competitive forces.

The crop insurance business achieved a significant turnaround from a loss-making position of R142 million in 2013 to an underwriting profit of R251 million in 2014. This business benefited from focused underwriting actions and benign weather conditions.

Santam Re achieved good profit growth, following lower retrocession costs and corrective action on the South African portfolio.

Should the volatility in the crop results over the two years be normalised, the net underwriting margins are as follows:

Normalised underwriting margin

	2014	2013
Underwriting margin achieved	8.7%	2.8%
Impact of ART Quota Share reinsurance arrangement	(0.5%)	N/A
Impact of crop results normalisation	(1.3%)	1.0%
Adjusted margin	6.9%	3.8%

This improvement in the 'normalised' underwriting margin is mainly attributed to benign weather-related claims experience in 2014 and a significant focus by management on process enhancements and corrective actions to improve the profitability of all the insurance businesses in the group.

Net catastrophe claims for 2014 amounted to R187 million compared to R280 million in 2013. The soft reinsurance market also provided opportunities to optimise reinsurance placements in 2014.

Net insurance results unpacked

	2014 R'm	% of NEP	2013 R'm	% of NEP	5-year average %	10-year average %
Net earned premium (NEP)	17 222	100.0	16 750	100.0	100.0	100.0
Claims incurred	10 878	63.1	11 607	69.3	65.9	67.1
Acquisition costs	4 850	28.2	4 666	27.9	27.7	26.6
Underwriting surplus	1 494	8.7	477	2.8	6.4	6.3
Investment return on insurance funds	425	2.5	374	2.2	2.6	2.9
Net insurance result	1 919	11.2	851	5.0	9.0	9.2
Combined ratio		91.3		97.2	93.6	93.7

The group achieved strong gross written premium growth of 12%, excluding cell insurance business and 10% inclusive of cells. The group reported strong gross written premium growth of 12% in the property class. Corrective underwriting actions as well as expansion into foreign territories contributed to growth of this class of business. The motor book grew by more than 8%, positively impacted by underwriting actions as well as an increase in MiWay gross written premiums to R1.5 billion (2013: R1.3 billion).

The specialist insurance classes had mixed fortunes with the liability class showing growth of only 4%, following the decision to reduce risk exposure to medical malpractice business as well as certain professional indemnity schemes. In contrast, the engineering and transportation classes achieved good growth, mainly driven by expansion into foreign territories. The crop insurance business also reported growth of 26% through increased exposure and a change in the crop mix. The growth of cell insurance business in the Alternative Risk class was negatively impacted following the cancellation of a book of business as well as the refund of premium on risk financing business. Personal lines and smaller commercial property risks benefited from corrective actions, while business expansion into foreign territories by the Specialist property business and Santam Re also contributed to growth in this business class.

Following South Africa's credit downgrade by global ratings agency Standard & Poor's (S&P) on 13 June 2014, Santam's long-term counterparty credit and insurer financial strength rating was adjusted from A- to BBB+, maintaining its maximum rating of two notches above the sovereign rating. At the same time, S&P affirmed the 'zaAA+' South Africa national scale rating on Santam, leaving our local policyholders and note holders unaffected. Alternative arrangements to support growth in territories outside of South Africa, in situations where this is dependent on Santam's S&P international scale rating, were put in place towards the end of 2013. In terms of these arrangements Santam has the facility to use an international insurer's AA-rated licence for such business. As part of the arrangement with the international insurer, Santam entered into an alternative risk transfer (ART) quota share agreement effective 1 January 2014, which reduced net earned premiums by R1 billion during this reporting period, reducing growth in net earned premiums to 3%. The agreement will generate dollar-denominated collateral to support Santam's use of the international insurer's AA-rated licence. The agreement also reduces Santam's net catastrophe exposure, resulting in lower catastrophe reinsurance premiums.

The net acquisition cost ratio of 28.2% increased from 27.9% in 2013. On a comparable basis, excluding the impact of the ART reinsurance quota share agreement, the management expense ratio increased by 1.2%. Variable incentive costs increased compared to 2013 following the significant improvement in underwriting performance and were a contributor to the expense ratio increases. Binder fees payable to intermediaries also increased following changes in regulations in 2013. Strategic project costs amounted to 1% of net earned premium and relate to continued investment in strategic projects to improve our online interaction capability, to centralise our back-office processing and to implement a new core underwriting, administration and product management platform for the Santam intermediated business. Development costs of R81 million for the latter project were capitalised in 2014. The project is progressing according to plan.

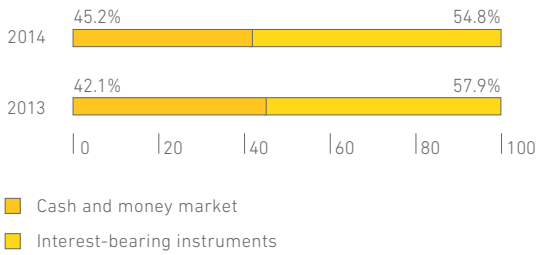
The net commission ratio reduced by 0.6% on a comparable basis. The decrease was mainly due to the higher reinsurance profit commissions and rebates received on specialist and crop insurance business as well as growth at MiWay, where no commission expenses are incurred.

In managing Santam's risk pool, we aim to retain an optimum amount of risk after reinsurance, taking into account the group's risk appetite and the cost of reinsurance. The level of reinsurance earned premium as a percentage of gross earned premium increased from 11.8% in 2013 to 13.7% in 2014 on a comparable basis, excluding the impact of the ART reinsurance arrangement and cell business. Favourable reinsurance terms on specialist business lines, and increased quota share treaties for the crop and Santam Re businesses, were key drivers for the increase.

INVESTMENT RETURN ON INSURANCE FUNDS

The assets backing the net insurance funds increased from R6.4 billion in December 2013 to R6.8 billion as at 31 December 2014. The assets backing the net insurance funds are invested as follows:

Assets backing net insurance funds



The investment return on insurance funds of R425 million increased from the R374 million earned in 2013, supported by a small increase in interest rates as well as a higher average insurance funds balance for the year.

Investment results

INVESTMENT INCOME

The performance of the interest-bearing portfolios on average exceeded the SteFI index while the listed equities marginally underperformed against the SWIX40 benchmark in 2014. The performance of the interest-bearing and equities portfolios continue to exceed the relative benchmarks over the longer term. The group's investment performance was negatively impacted by the 2013 hedge over equities, which expired in May 2014 at a loss of R93 million. The weakening of the rand during 2014 had a positive impact on the valuation of foreign currency assets held by our local operations of R71 million (2013: R91 million).

Positive fair value movements to the value of R93 million in Santam's interest in SEM's general insurance businesses in Africa, India and Southeast Asia enhanced the investment performance. A dividend of R21 million from the SEM portfolio was also included in investment income. The investment in the SEM portfolio generated a return of 19% before tax during 2014.

Net earnings from associated companies of R58 million lagged the R86 million reported in 2013 mainly due to the key contributor, Credit Guarantee Insurance Corporation of Africa Ltd reporting lower earnings compared to 2013.

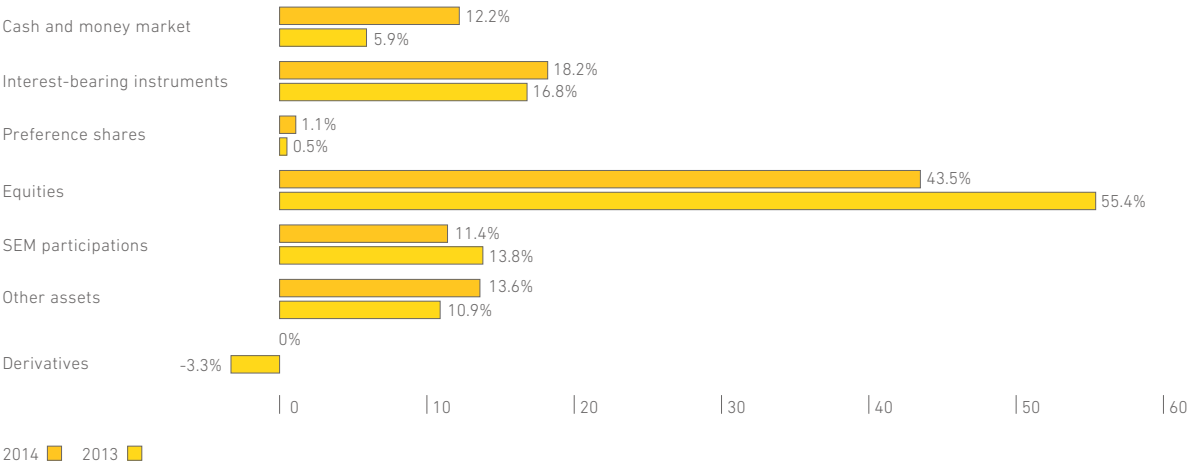
Earnings were negatively impacted by an impairment of R69 million in the investment in the Indwe Broker Holdings Group (Pty) Ltd (Indwe). The impairment was mainly driven by reduced growth projections in competitive market conditions and the reduced income for the Indwe group following the disposal of Original Co-Sourcing SA (Pty) Ltd (Orico) to Brolink (Pty) Ltd (Brolink).

INVESTMENT APPROACH

Santam follows a policy of managing its investment portfolios in a diversified manner. Our aim is to optimise investment income within the approved risk appetite profile. Detail on risk management practices can be found in note 4 to the annual financial statements.

The asset allocation is also managed and monitored from an asset/liability perspective. This ensures that there are sufficient liquid funds available to meet Santam's insurance liabilities, to

Shareholder assets



ensure that the subordinated debt obligations are adequately covered by matching interest-bearing instruments and that the shareholders' funds are not unduly exposed to investment risk.

Investment management is outsourced to Sanlam Investment Management, an external fund manager under predetermined mandates, which consists of a combination of various benchmarks, inter alia, SWIX40 and SteFi. The overall performance of the fund manager against the mandates is monitored and tracked by management and reported to the Santam investment committee and board on a quarterly basis. The mandate guidelines include performance objectives, market risk limitations such as tracking error and duration, asset allocation, credit and exposure limitations, the use of derivative structures and compliance with relevant FSB regulations.

Towards the end of 2014, a portion of the funds (R820 million) backing the insurance liabilities and capital relating to the business written in foreign currency onto the Santam licence was invested in global fixed income portfolios. These funds were previously held in client foreign currency bank accounts, but dispensation was obtained from SARB to invest these funds in managed portfolios. This enables Santam to improve the investment yield previously earned on these funds.

SEM participation investments

Santam entered into a series of transactions with SEM in December 2013 in terms of which Santam acquired participation interests in SEM's emerging markets short-term insurance. Santam subscribed for shares of separate classes in SEM with each separate class linked to one of the following participation interests:

Santam accounts for these investments as fair value through income financial instruments; the changes in market value are included in the income statement.

The co-investment arrangement positions SEM as a single investor for the Sanlam group's general insurance businesses in emerging markets, while enabling Santam to share in the economic interest of the current and future general insurance

SEM investment holdings

	Incorporated in	Santam effective holding 2014 %	Santam effective holding 2013 %
Pacific & Orient Insurance Co. Berhad	Malaysia	15.4	15.4
Shriram General Insurance Co. Ltd	India	7.0	7.0
BIHL Insurance Company Ltd	Botswana	20.4	18.6
NICO Holdings general insurance subsidiaries	Malawi, Zambia, Uganda	21.6	8.7
NICO Holdings general insurance subsidiaries	Tanzania	14.4	5.7
Soras Assurance Generales Ltd	Rwanda	22.1	–
Socar SA Burundi	Burundi	7.3	–
Oasis Insurance plc	Nigeria	8.7	–
Enterprise Insurance Company Ltd	Ghana	14.0	–

SEM participation investments

Region	2013 R'm	Additions R'm	Fair value movements R'm	2014 R'm
Africa	21	186	2	209
Southeast Asia	301	–	47	348
India	206	–	44	250
	528	186	93	807

expansion in these markets. In principle, SEM and Santam will participate on a 65%/35% basis, respectively, in the Sanlam group's general insurance businesses in emerging markets. Through this participation, Santam obtains exposure to the Indian, Malaysian and African emerging markets, and has the opportunity to participate in the Sanlam group's future emerging markets general insurance investments. Santam renders technical services to the SEM general insurance partner companies.

The SEM investments now account for 11.4% of the Santam group's shareholder funds.

Capital management and solvency

CAPITAL MANAGEMENT PHILOSOPHY

Santam's capital management philosophy is to maximise the return on shareholders' capital within an appropriate risk appetite framework. The aim is to increase shareholder wealth by actively managing the following:

- The amount and sources of capital in the business. This is also linked to the current and future regulatory capital requirements in terms of the existing and the newly formulated SAM requirements.
- The allocation of capital to business units or new business ventures/acquisitions.
- The amount and type of risk that the company is willing to assume in the pursuit of value creation.
- The reinsurance programme and asset allocation to optimise economic capital requirements.

Santam targets a return on capital hurdle rate of 22.5%. Capital is allocated to the various businesses in the group and the returns on these businesses are measured against the required hurdle rate.

DISCRETIONARY CAPITAL AND SOLVENCY LEVEL

Santam's board of directors targets a solvency level between 35% and 45% of net written premium for the group, which is equivalent to a capital coverage ratio of 135% to 170%. The group economic capital based on the internal model currently amounts to R4.7 billion or an economic capital coverage ratio of 167%. Excess capital is maintained for the following reasons:

- To make an allowance for model risk based on the complexity of the underlying business
- To maintain a margin over the current statutory capital requirement
- To maintain Santam's insurer financial strength credit ratings
- To fund business growth and allow for any corporate actions

The group solvency ratio of 45.6% at 31 December 2014 marginally exceeded our targeted solvency range. Net asset value per share increased from 5 360 cents at the end of 2013 to 6 115 cents at the end of 2014 mainly driven by the good insurance and investment earnings generated during the year. We will continue monitoring our solvency levels and required solvency range in light of industry changes and regulatory requirements.

We remain committed to efficient capital management.

REGULATORY SOLVENCY AND CAPITAL REQUIREMENTS

One of the most important regulatory developments is the new solvency regime (SAM) that the FSB is in the process of developing for the South African long-term and general insurance industries to be in line with international standards. SAM will adopt the principles of the Solvency II, adapted to South African-specific circumstances, where necessary. The target date for implementation of the final requirements under the new regime, including the internal model approach for general insurers is 1 January 2016.

As previously reported, Santam operates an internal capital model in line with best practice to assist management with capital management, risk quantification and decision-making.

Santam is in the process of applying to the FSB to use this internal model for determining its capital requirements once SAM is enacted. We expect that capital requirements under this approach will be slightly lower than the current interim measures solvency requirement of 28.5%.

Dividends

The company paid an interim dividend of 262 cents per share, which was 8.3% higher than the 242 cents per share in 2013. Santam declared a final dividend of 480 cents per share for 2014 (2013: 433 cents per share) resulting in a total dividend of 742 cents per share for the year (2013: 675 cents per share). This represents an increase of 9.9%.

Santam's dividend policy aims for stable dividend growth in line with the company's long-term sustainable business growth. When special dividends are being considered, we take into account capital levels (as informed by the solvency margin target range of 35% to 45% and regulatory capital requirements) and potential investment opportunities.

Corporate actions

Santam concluded the acquisition of a 100% interest in Brolink in 2014. Following the acquisition, Santam consolidated its administration businesses. Orico (previously owned by Indwe) and the part of the Riscor Underwriting Managers (Pty) Ltd business not operated on Santam's in-house systems were integrated with Brolink effective 1 October 2014.

Full details of the company's holdings in subsidiaries and associated companies are contained in note 47 to the annual financial statements.

Regulatory environment

The regulatory environment remains dynamic with a number of developments in progress, including the promulgation of Treating Customers Fairly regulations, the recently published Retail Distribution Review and the SAM framework. Our approach to legal compliance and the philosophy is discussed in detail in the corporate governance report and further details on these regulatory developments are included on page 60.

HENNIE NEL
Chief financial officer